Victory INCORE Total Return Bond Fund
Quarterly Commentary

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As of September 30, 2019

Recession Risks Are Rising: The Consumer Is the Key

The check engine light on the domestic economy started flashing yellow in the third quarter. Taking a closer look under the hood, robust consumer spending remains the key driver to the economy, but weak global manufacturing demand and tight monetary policy are working to slow the economic engine.

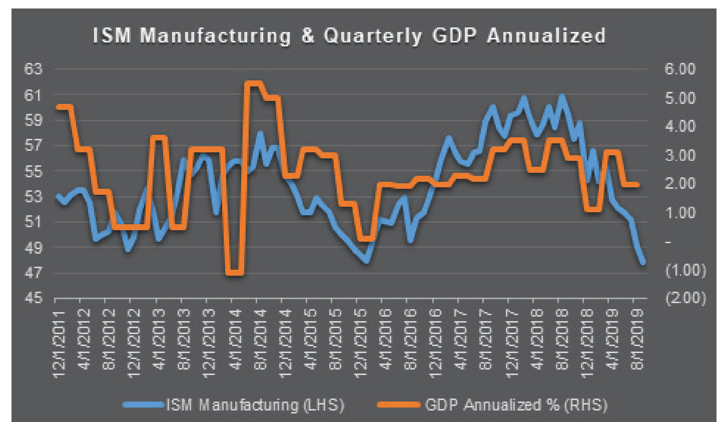
The U.S. consumer appears by many measures to be alive and willing to spend, which is critical in the coming quarters. Final Q2 GDP data released the last week of September showed Personal Consumption Expenditures contributing a healthy 3.0% annualized rate to GDP in Q2. At the time of this writing, retail sales data in Q3 for July and August indicate a robust average annual rate of 3.9% YOY growth so far. While payrolls growth has slightly increased (from 152K jobs/month to approximately 157K jobs/month), U3 unemployment (at 3.5% in September) remains at levels not seen in 50 years, and U6 underemployment in September (at 6.9%) is tied with all-time lows not seen since December 2000. Annual wage growth in the third quarter averaged 3.1% YOY. Absent a significant downturn in employment or wages, we expect the consumer will continue to contribute positively to GDP over the next several quarters, and this is critical to prevent the economic engine from stalling.

Meanwhile, global leaders in the U.S., China, Great Britain, and Europe remain dedicated to their campaigns of maximum unpredictability with regard to trade policy in an effort to gain negotiating advantages as tensions escalate and cause the engine to become sluggish. Final numbers for Q2 reported in September showed that Gross Private Domestic Investment detracted 1.2% from GDP, and it appears as if investment in inventories has slowed in Q3. Manufacturing indexes both domestically and globally deteriorated in Q3 as tariffs and trade tensions began to bite. As shown in the table below, the Markit Global Manufacturing Purchasing Managers' Index (PMI) has been below 50 for several months (which is contractionary), and four out of eight major U.S. trading partners are also below 50, while the U.S. hovers just above that important level.

Markit Worldwide Manufacturing Purchasing Managers' Indexes

Index	6/30/19	7/31/19	8/31/19	9/30/19
Global	49.4	49.3	49.5	49.7
U.S.	50.6	50.4	50.3	51.1
Canada	49.2	50.2	49.1	51.0
Mexico	49.2	49.8	49.0	49.1
Germany	45.0	43.2	43.5	41.7
France	51.9	49.7	51.1	50.1
Great Britain	48.0	48.0	47.4	48.3
China	50.6	50.9	51.6	51.6
India	52.1	52.5	51.4	51.4
Japan	49.3	49.4	49.3	48.9

Another measure of domestic manufacturing, the Institute for Supply Management Manufacturing PMI (ISM PMI), printed 49.1 for August and 47.8 for September, which indicates contraction. It's true that consumption contributes approximately 70% of U.S. GDP, yet the slowdown in domestic manufacturing should not be ignored. As the chart below shows, quarterly GDP often follows the direction of the ISM PMI, and because ISM PMI is reported earlier it tends to be a leading indicator. While we may not experience an outright recession in the U.S., it seems likely that GDP will deteriorate further from current levels in coming quarters. Furthermore, we're skeptical that any comprehensive trade agreement with China will be reached prior to the 2020 election. Finally, with the UAW strike at GM entering its third week at the time of this writing, and the Teamsters honoring the strike, we expect a negative impact on manufacturing and GDP if the strike continues much longer. Once the strike is resolved, however, we would expect to see a rebound. As of this writing, the Atlanta Fed's GDPNow estimate for Q3 is at 1.80% and the New York Fed's Nowcast Q3 estimate is at 2.10%.



Source: Bloomberg, Institute for Supply Management, U.S. Bureau of Economic Analysis.

Despite protestations to the contrary by the Federal Reserve, an inverted yield curve is a sign of overly tight monetary conditions relative to current economic conditions. We believe the Fed overtightened monetary policy in 2018 and never would have gotten the federal funds rate to 2.50% absent the fiscal stimulus provided by tax cuts. Additionally, the Fed further tightened monetary conditions via quantitative tightening, or balance sheet reduction, in 2019. Now that the marginal stimulus from tax cuts has faded, the Federal Reserve has reversed course and joined the global easing trend by cutting interest rates by 0.50% over two meetings in July and September. Currently, the upper bound for the federal funds target rate stands at 2.00%. We believe the Fed will need to further reduce the federal funds rate upper bound to 1.50% by the end of Q1 2020 to avoid recession and extend the recovery. The Fed has many academics who believe that low unemployment causes inflation despite several years of

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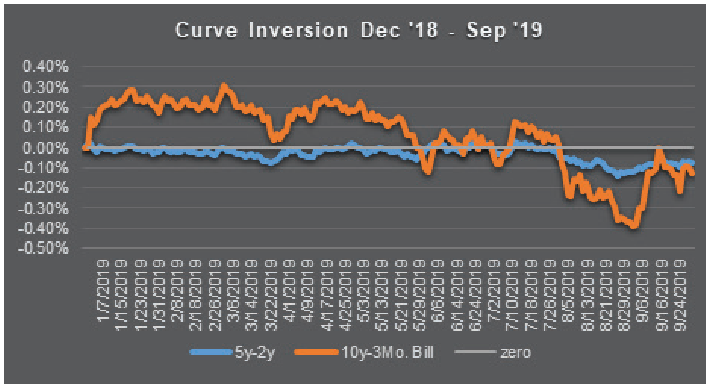
data to the contrary. The risk of the Fed being stubborn or too slow to cut rates is a real concern.



The U.S. yield curve between 2-year U.S. Treasury notes and 5-year U.S. Treasury notes has been inverted for the majority of 2019, while the yield curve between 3-month T-bills and 10-year Treasury notes first inverted during this cycle in May 2019 and has been inverted for 73% of the trading days in Q3, staying completely inverted since August 1, 2019. Source: Bloomberg.

If that wasn't already a strong enough sign of overly tight monetary conditions, overnight funding rates soared in mid-September, causing the federal funds rate to reach 2.30%, breaking the Fed's upper bound of 2.25% in September, while overnight repo rates spiked as high as 10% and SOFR (the future replacement for LIBOR) reached 5.25%. Volatility in short-term funding markets forced the Federal Reserve Bank of New York to provide repurchase operations for the first time in over a decade, as some banks and/or primary dealers were short of required regulatory reserves (required cash on deposit at the Federal Reserve relative to liabilities). Ultimately, the Fed was required to pump nearly $200 billion into the overnight lending markets to stabilize interest rates. This is a sign that quantitative tightening has gone too far.

Market Summary

Q3 was a wild ride for rates markets, with the majority of volatility coming in both August and September. August kicked off the month with President Trump practicing the art of unpredictability by taking advantage of a Fed rate cut the prior day and threatening a tariff of 10% on an additional $300 billion of Chinese goods. China responded by announcing a suspension of all purchases of U.S. agricultural products and devalued the Chinese yuan (CNY) to above 7 CNY per U.S. dollar (USD). By August 13 the U.S. Trade Representative announced the removal of some products from the tariff list, as well as a delay until December 15 for products such as cell phones, laptops, video game consoles, etc. While the easing of rhetoric was welcome, it wasn't enough to offset deteriorating manufacturing numbers, both domestically and abroad. In the face of this deterioration, hawkish Fed-speak caused further flight to quality in rates markets and 30-year Treasury rates closed at an all-time historic low of 1.95% near the end of August, while 10-year Treasury rates finished the month at 1.50%. Two weeks later, responding to strong retail sales numbers and firming core CPI, 30-year and 10-year Treasury rates moved up approximately 40+ basis points (to 2.37% and 1.90%, respectively). As we approached the middle of September, funding pressures in overnight funding markets became apparent as the federal funds rate breached its upper bound and repo rates soared. Additionally, Iranian bombing of oil facilities in Saudi Arabia heightened geopolitical tensions and 30-year and 10-year Treasury rates moved lower by about 23-26 basis points, closing the quarter at 2.11% and 1.67%, respectively. Volatile indeed. Both large-cap stocks and bonds finished the quarter in positive territory, with bonds leading the way. Despite the volatility, corporate bonds, with the exception of investment grade industrials, managed to deliver positive excess returns for the quarter (returns in excess of a duration-matched basket of Treasury securities). High-grade municipals had a nice quarter but couldn't keep up with the strong run in Treasuries. Munis ended Q2 at historically rich levels relative to Treasuries but cheapened a bit as much-needed supply finally hit the market in September. Demand remains strong, however, so a seasonal increase in supply should be easily absorbed. Quarterly returns for various market sectors are provided below:

Market/Benchmark	Q3 2019 Total Return	Q3 2019 Excess Return
U.S. Treasury 3-Month Bill	0.57%	*
U.S. Treasury 2-Year	0.52%	*
U.S. Treasury 5-Year	1.33%	*
U.S. Treasury 10-Year	3.19%	*
U.S. Treasury 30-Year	9.21%	*
U.S. Aggregate	2.27%	0.05%
U.S. Corporate Investment Grade	3.05%	0.04%
U.S. Corporate High Yield	1.33%	0.19%
Invest. Grade: Financial Institutions	2.33%	0.14%
Invest. Grade: Industrial	3.26%	-0.03%
Invest. Grade: Utility	4.47%	0.14%
Municipal Bond Index	1.58%	*
S&P 500	1.70%	*

Source: Bloomberg.

Market Positioning

We have been positioned defensively throughout 2019 and remain so for three reasons. First, the shape of the yield curve indicates that monetary policy is excessively tight relative to economic conditions, which creates a heightened risk of recession. We also view the curve as a proxy for risk premium, or what an investor is getting paid to take risk. In a steep curve environment, investors are generally paid well to take on additional risk; in the flat or inverted curve environment in which we find ourselves now, they are not. Second, yield pickup or spread on credit remains near cycle lows, and the yield premium over Treasuries isn't enough to justify taking a large overweight position. With credit spreads this tight, we feel the risks in owning credit are asymmetric, meaning there's more room for spread widening (credit underperformance) as opposed to spread tightening (credit outperformance), which doesn't justify a large overweight position. Finally, the global slowdown in manufacturing is being caused by trade disputes that we don't expect will be resolved prior to the 2020 election. The balance of risks and lack of sufficient risk

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premium indicates that now is not the time to reach for yield. We have been flat to slightly overweight investment grade credit, and in high yield we've maintained less than one-third of our maximum allowable position. To add modest yield to the portfolios we have maintained overweights in 1-5 year, well-structured agency CMOs (agency collateralized mortgage obligations).

Attribution

Victory INCORE Total Return Bond Fund: The Fund trailed the Bloomberg Barclays U.S. Aggregate Bond Index in the third quarter. Sector allocation to industrials detracted from performance, while credit selection and duration/yield curve positioning were additive, but not enough to surpass the benchmark.

Performance quoted represents past performance and does not guarantee future results.

Risks Associated with Investing in the Fund: There is no guarantee that the Fund will achieve its objective. All investing involves risk, including potential loss of principal. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. When interest rates rise bond prices fall. To the extent the Fund invests a greater amount in any one sector, the Fund's performance will depend to a greater extent on the overall condition of that sector, and there is increased risk to the Fund if conditions adversely affect that sector. A significant portion of the Fund is invested in mortgage-backed securities, which are subject to higher prepayment risk than corporate bonds and notes, particularly in periods of declining interest rates, and are subject to the risk that an unexpected rise in interest rates will extend the life of the security beyond the expected repayment time, typically reducing the security's value. In addition, the Fund invests in to-be announced (TBA) and dollar-roll transactions, which involve the risk that the security will decline in value between the purchase date and the delivery or issue date, the risk that value of the security the Fund is required to buy will be less than an identical security, and the risk that the counterparty will fail to deliver. The Fund invests in credit default swaps, which involve the risk that small price movements can result in substantial gains or losses. The Fund also invests in dollar-denominated securities of foreign issuers, which involve additional risks due to foreign economic and political conditions, and differences in financial reporting standards. The return of principal in bond funds is not guaranteed. Investments in below-investment-grade debt securities ("junk bonds") may be less liquid and are subject to a greater risk of loss than investment-grade securities. Such securities may experience greater price volatility and higher default rates during periods of adverse market conditions.

Indexes Defined: The Bloomberg Barclays U.S. Aggregate Bond Index measures the performance of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable rate mortgage (ARM) pass-throughs), asset-backed securities and commercial mortgage-backed securities. Securities indexes assume reinvestment of all distributions and interest payments and do not take into account brokerage fees or taxes. Securities in the Fund may not match those in the index and performance of the Fund will differ. Direct investment in an index is not possible.

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